January 30, 2007

Minutes of the Meeting of the
Treasury Borrowing Advisory Committee
of the Bond Market Association
January 30, 2007

The Committee convened in closed session at the Hay-Adams Hotel at 10:30 a.m. All Committee members were present except Mohammed El-Erain. Under Secretary Robert Steel, Assistant Secretary Anthony Ryan, Deputy Assistant Secretary Matthew Abbott, and Office of Debt Management Director Karthik Ramanathan welcomed the Committee and gave them the charge.

Director Ramanathan presented a series of charts (see attached) highlighting recent trends in the fiscal outlook, noting that US economic growth remains healthy and continues to outpace expectations. From a fiscal perspective, corporate taxes and individual taxes remain strong while non-withheld taxes continue to grow as portion of government revenues. Several macroeconomic factors support these positive trends in the fiscal outlook, including the rise in after-tax corporate profits, a strong equity market, and low unemployment.

Ramanathan noted that while Treasury remains vigilant in monitoring potential headwinds that may impact the current encouraging trends - including uneven growth in the housing market and volatility in energy markets - the favorable budget outlook would imply reductions in debt issuance over the current fiscal year. The improvement in the budget deficit, from nearly 3.5 percent of GDP just three years ago to 1.9 percent of GDP in 2006 has been significant. According to Ramanathan, many market participants had recently adjusted their deficit forecast and borrowing estimates to account for the resilience in the US economy and its positive impact on the budget situation.

Ramanathan stated that strong receipts, coupled with moderate growth in expenditures, have resulted in lower borrowing needs. If this trend, now in its third year, continues, reductions in debt issuance would be needed.

The Committee then turned to the first question in the Committee charge (attached) regarding Treasury's debt issuance strategy in light of the continued positive trends from a fiscal and macroeconomic perspective.

In their discussion, members noted that it was difficult to forecast deficits past FY2007 because forecast errors are generally large and substantial, regardless of the source of such forecasts. One member commented that Treasury's past approach to responding to reduced borrowing needs has been to first reduce bill issuance. If changes are more secular, Treasury would make changes to coupons, first by reducing issue sizes until liquidity becomes a concern, then reducing auction frequencies, and then eliminating issues altogether. The member stated that it would be worthwhile describing and reiterating this paradigm along with other strategies for dealing with short-term and long-term borrowing needs in the policy statement.

One member noted that even over the near term, profit growth was slowing and that fiscal policy is a sizable unknown. Another member noted that tax receipts tended to be pro-cyclical with economic growth, and that the fiscal improvement could be greater than expected given current trends. A few members observed that structurally, over the next three to four years as baby boomers enter retirement, Treasury's borrowing needs will increase. With that in mind, members discussed ways of addressing lower borrowing needs over the near- to intermediate-term.

Some members advocated cutting bills further from current levels. They felt that the bill market could handle reduced issuance. Several members noted that coupons could be trimmed further without impacting liquidity, particularly in the short end of the curve. Another member suggested eliminating the 10-year nominal reopening. Others thought that it made sense to look at eliminating a short or intermediate coupon issue. A consensus seemed to develop around eliminating one of two securities – the 5-year TIPS or the 3-year nominal note.

Members noted that the 5-year TIPS is a trading vehicle that does not offer significant advantages to investors seeking long-term inflation protection. The security reacts mainly to commodity price changes. Real money demand for TIPS remains concentrated in longer-dated issues. Members generally thought that if Treasury needed to eliminate an issue, it would be appropriate to eliminate the 5-year TIPS. However, one member noted that there was not a lot to be gained from eliminating the 5-year TIPS in FY07 because 1) the offering size is not that great and 2) given Treasury's standard practice of being transparent and providing six months notice to the market, changes would have an impact in FY08, not the current fiscal year.

Members also felt that eliminating the 3-year nominal note could be another alternative. They noted that there is not as much sponsorship in this issue vis-a-vis the 2-year note and the 5-year note. The lack of a futures contract for the 3-year note also made the security more suitable for elimination. In addition, eliminating the 3-year note, even with six months advance notice, would help to reduce borrowing in FY2007. Several members thought that given that borrowing needs were going to increase in the next three to four years, removing the 3-year note at this point was prudent a structural perspective as opposed to adjusting longer-dated issues.

Members felt that reintroducing securities in the short end of the curve would be less costly than in the long-end, and that Treasury's past experience had shown that it could leave a sector and return at some future date if needed.

Members also expressed the belief that Treasury should adhere to the practice of providing markets with six months advance notice of substantial calendar changes. Doing so minimizes premiums associated with supply changes and mitigates market disruptions.

Next, the Committee addressed the second question in the Committee charge regarding Treasury's debt issuance as it relates to short-term borrowing needs. In particular, the Committee was asked to address Treasury's short-term debt issuance given the volatility in its borrowing needs. One Committee member presented a series of charts (attached) discussing this topic.

The member began by reviewing borrowing-need volatility. The member presented data showing that 1) receipts were significantly more volatile than outlays and 2) that volatility has increased over the years. Factors driving increased volatility include the economic cycle, energy prices, congressional spending, demographics and changes in tax provisions. The volatility created significant forecast errors.

The member then reviewed how Treasury has addressed these volatility issues through recent innovations and effective use of short-term debt instruments. These innovations included the introduction of 4-week bills, more effective use of cash-management bills, and the suspension of 52-week bills. On the investment side, Treasury has found ways to better manage volatility during times of high cash balances, while increasing the return on cash balances through the use of the term-investment option and the pilot repurchase agreement programs, and by relying less on TT&L accounts.

The member next reviewed enhancements to the securities-trading infrastructure across Treasury, the Federal Reserve and the private sector. These enhancements have been designed to provide capacity in the event of unforeseen market disruptions that may cause volatility in borrowing needs. The main enhancement undertaken by all parties involved include fully staffed, live, geographically-diversified, contingent operating centers. These improvements serve Treasury well in the event of a market disruption.

The member then broached other alternatives for addressing short-term borrowing needs in a contingency event including those suggested in a September 2006 GAO report on short-term financing. To address an unexpected short-fall in cash, GAO recommended that Treasury look at establishing credit lines, consider private placements of cash management bills, and/or establish authority to borrow directly from the Federal Reserve during periods of wide-scale disruption. The member pointed out difficulties with all these GAO suggestions, including the significant costs of credit lines, the possible inability of institutions to participate in providing credit during a crisis, and the necessity that the clearing a settlement infrastructure to be intact for doing private placements. They also questioned the wisdom of borrowing from the Federal Reserve, and noted the likely difficulties in obtaining the authority to allow the Federal Reserve to lend directly to the Treasury. The member also suggested that Treasury consider tri-party repo arrangements, acknowledging that it also is problematic if the settlement infrastructure is not functioning.

Members generally felt that given the nature of crises, and the infrastructure currently in place, Treasury was well placed to deal with any contingent event. One member pointed out that the Treasury and the Fed have done a good job in navigating these crises in the past as witnessed by 9/11. Several members noted that cash management bills were the primary vehicle in dealing with a short term financing contingency, and Treasury currently has a strong program in place. Other members noted that the recommendations made by the GAO were not optimal and that cash management bills were the most appropriate method of addressing a severe contingency event – a process which is already well established with market participants.

The Committee agreed that Treasury's short term debt issuance in the face of increasing volatility has been very effective, and recommended continued transparency and predictability in addressing future volatility.

Next the Committee addressed the third item in the charge regarding competitiveness in the US Treasury market, and any steps that could be undertaken to ensure that the Treasury market remained the preeminent debt market. Deputy Assistant Secretary Abbott presented a series of charts highlighting prominent characteristics of the US Treasury market including trading volume in relation to other sovereign debt markets as well as other indicators of robust liquidity including narrow bid-ask spreads, an evolving investor base, increasing trade sizes, strong primary auction demand, and the growth of the inflation-linked debt market.

Abbott noted that Treasury would continue to foster deep, liquid markets by remaining transparent in its actions, issuing debt in a regular and predictable manner, and minimizing regulatory burdens on market participants. These guiding principles, which have resulted in the deepest, most liquid debt market approach in the world, were also part of Treasury's overarching approach to global capital markets as discussed by Secretary of the Treasury Henry Paulson in his recent discussions on competitiveness.

Abbott stated that Treasury remains committed to strengthening US capital markets by adhering to well grounded principles including: maintaining a global perspective, providing an evolving regulatory structure, establishing rules on sound principles, approaching regulation from a risk-based approach, and providing enforcement to deter bad behavior, not to hinder innovation or responsible risk taking.

In discussions following the presentation, one member noted that Treasury can not "over communicate". Another member added that keeping a light regulatory touch on the markets was critical and embracing new, more efficient technologies was beneficial. This member suggested that Treasury look at the compliance process around bid submission, noting that there is still too much human intervention, and that the cost for manual error was still high.

Another member noted that Treasury, as the world's largest issuer, might be able to do more in the area of helping to set issuer standards around the globe. One potential area of concern was that the Treasury market relies heavily on "recycling" securities back into the markets via repurchase agreements. Treasury should consider ways to assure that these securities will continue to be available in the market.

Another member noted that Treasury has done a commendable job in helping to promote competitiveness in markets, and that in terms of providing information to markets, its methods of distributing information was more effective than any other sovereign.

Finally, the Committee discussed its borrowing recommendations for the February refunding and the remaining financing for this quarter as well as the April – June quarter. Charts containing the Committee’s recommendations are attached.

The meeting adjourned at 11:50 a.m.

The Committee reconvened at the Hay-Adams Hotel at 5:30 p.m. All the Committee members were present except Mohammed El-Erain. The Chairman presented the Committee report to Assistant Secretary Ryan. A brief discussion followed the Chairman's presentation but did not raise significant questions regarding the report's content.

The meeting adjourned at 5:45 p.m.

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Karthik Ramanathan
Director
Office of Debt Management
January 30, 2007

Certified by:

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Thomas G. Maheras, Chairman
Treasury Borrowing Advisory Committee
Of The Bond Market Association
January 30, 2007

Attachments:

Link to the Treasury Borrowing Advisory Committee discussion charts

Treasury Borrowing Advisory Committee Quarterly Meeting
Committee Charge – January 30, 2007

Fiscal Outlook

Given recent trends in the fiscal outlook, what are the TBAC's thoughts on Treasury's debt issuance?

Short Term Debt Issuance

We would like the Committee's views on Treasury debt issuance as it relates to short-term borrowing needs. Are there alternative schedules, instruments, or other issues that Treasury should consider in managing its short-term debt issuance given the volatility in its borrowing needs?

Competitiveness of the US Treasury Market

Recognizing that capital markets are constantly evolving and growing, are there any steps that we should undertake to ensure that the Treasury market remains the preeminent debt market?

Financing this Quarter

We would like the Committee's advice on the following:

- The composition of Treasury notes and bonds to refund approximately $35.1 billion of privately held notes maturing on February 15, 2007.
- The composition of Treasury marketable financing for the remainder of the January-March quarter, including cash management bills.
- The composition of Treasury marketable financing for the April-June quarter.